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Treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries

Note by the Working Group on Treatment of Islamic Financial Instruments*

Summary

Islamic financial instruments may take different forms, but the main types of contracts are *musharaka*, *mudaraba*, *murabaha*, *ijara*, *salam*, *istisna'a* and *sukuk*, which is a form of securitization of other contracts.

The taxation of income from Islamic financial instruments depends primarily on the characteristics of such income. To this end, we distinguish between a legal (or form-based) approach, which characterizes income according to the legal form of the contract, and an economic approach, which looks to the substance or the economic reality of the contract or transaction. The latter recharacterizes most of the contracts mentioned above into a loan and treats the payment made thereunder as interest.

The current drafting of the United Nations Model Double Taxation Convention between Developed and Developing Countries seems to be capable to deal with Islamic financial instruments, but some language could be included in the commentary to provide that the definition of interest would include income from some types of Islamic financial arrangements that are characterized as debts relations, although, legally, they are not. More details could be included in the negotiation manual.

* Based on contributions submitted by the following members of the working group: Andrew Dawson, Salah Gueydi and Victor Thuronyi; the views and opinions expressed are those of the authors and do not necessarily represent those of the United Nations.

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I. Introduction

1. Following a presentation made by Moftah Jassim al-Moftah and Salah Gueydi on the treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries (ST/ESAIPAD/SER.E/21) during the second session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 30 October to 3 November 2006, it was decided that further work was needed to obtain a better understanding of the issues involved. To that end, a new working group on the treatment of Islamic financial instruments (was formed under the coordination of Mr. al-Moftah (expert, Qatar) and the membership of Andrew Dawson (expert, United Kingdom) and observers from Malaysia (Khodijah Abdullah), Qatar (Salah Gueydi), the Sudan (Gabir Saad el-Din), the Organization for Economic Cooperation and Development (OECD) (Jacques Sasseville) and the International Monetary Fund (Victor T. Thuronyi).

2. Members of the working group were requested to submit their contributions on the subject taking into account the need to cover the following items:

(a) The main Islamic financial instruments available in the country they represent (if any);

(b) Tax treatment of those instruments in their countries, or, if they do not represent a country, provisions of the model that would apply to the instruments.

3. Most members of the working group submitted a contribution in keeping with the above. The present note, which is based mainly on these contributions, proposes to present the main contracts and transactions used in Islamic finance (see sect. II) and to discuss tax issues related to these contracts and transactions, taking into account the provisions of the United Nations Model (and its commentary) on one hand, and the tax provisions dealing with the subject in countries where Islamic finance is practised, on the other hand (see sect. III). The concluding section discusses whether or not to recommend that the United Nations Model and/or commentary (and/or negotiation manual) include language to deal with Islamic finance (see sect. IV).

II. Main Islamic financial instruments

4. The following types of contracts and instruments are addressed below: *musharaka*, *mudaraba*, *murabaha*, *ijara*, *salam*, *istisna'a* and *sukuk*. The descriptions are general, and it should be borne in mind that specific transactions may vary and, accordingly, the tax consequences of a specific transaction may vary depending on the specific facts of the transaction.

A. *Musharaka*

5. Literally, *musharaka* means partnership. It is an equity participation contract whereby the partners or shareholders (usually the bank(s) and the client(s)) contribute jointly to finance a project. Profits and losses are split according to a pre-agreed formula. *Musharaka* may be considered as a form of partnership.

6. A variant of this form is the "diminishing *musharaka*", which is a partnership agreement (*musharaka*) with provision for gradual buyout of one of the partners. It can be used, for example, when a person wishes to buy a house. He would enter into a partnership agreement with a bank, and put down 10 per cent of the purchase price, with the bank supplying 90 per cent. They would have joint beneficial ownership of the house, and would enter into an agreement that the customer would pay rent to the bank for the exclusive right to use the bank's 90-per cent share of the property. The customer would also make capital repayments to the bank, effectively buying out its share, so that eventually the customer would be the outright owner of the property.

B. *Mudaraba*

7. This is an investment partnership whereby an investor (also called *rabbu al-mal*, or owner of money) agrees to provide money to another party (also called *mudarib*, or entrepreneur) in order to invest the same or undertake a business activity. Profits are distributed on the basis of a pre-agreed formula, while losses are borne exclusively by the investor. The entrepreneur does not receive any income in case of loss.

8. The *mudaraba* offers a perfect (sharia compliant) framework for profit-sharing deposits. Under this scheme, a depositor would deposit money with a financial institution (an Islamic bank). The money would be used by the institution with a view to producing a profit. From time to time the institution would credit the depositor with amounts out of the profits it earns. The depositor would not be permitted to assume any role in the investing decision of the institution.

C. *Murabaha*

9. Literally, *murabaha* means a sale on mutually agreed profit. Technically, it is a form of asset-based finance whereby the capital provider (bank), instead of lending out money, purchases a commodity (equipment, property, etc.), on the request of the capital user (client), from a third party at an open market price and resells it at a predetermined higher price to the capital user. The latter will pay the price in instalments obtaining thereby a credit without paying interest.

10. The validity of the *murabaha* contract (from a sharia perspective) is subject to stringent conditions. Most of them are on the onus of the capital provider (bank), such as the disclosure of the original costs (purchasing price and other costs) and the profit margin at the time of agreement, not selling the commodity before it obtains its ownership and possession, and actually assuming ownership risks (i.e. relating to the loss of the commodity), etc.

11. A variation of *murabaha* is an arrangement whereby the bank purchases a tradable commodity, such as gold (or rather a title to gold, since the bullion never physically moves), which is sold to the customer on deferred payment terms. The customer immediately sells the commodity on the open market to obtain cash. Under such an arrangement, which raises some concerns as to its sharia compliance, the bank's customer is effectively borrowing money from the bank.

D. *Ijara*

12. *Ijara* means literally to rent. It covers, in Islamic jurisprudence, the usufruct of assets and property (rental) and the hire of services of a person for a wage.

13. As a financing mode, *ijara* is a straightforward lease, under which a financial institution buys an asset (such as an equipment) and leases it to a customer. It can cover both operating and finance leases.

14. A variety of this contract is called *ijara waktina*, an equivalent to a hire purchase arrangement, under which an asset is leased, with a sale to the lessee at the end of the period.

E. *Salam*

15. A *bai essalam* (or *salam*) contract is, in simple terms, a "sale" transaction, whereby the price (called also capital) is immediately payable and the delivery of the commodity is deferred. The objective of the contract is to provide immediate cash to the seller to finance his activity and to provide the buyer with the commodity at a relatively low price. Scholars discussed the nature of the contract and, consequently, determined the elements and conditions of its validity.

16. Generally speaking, the contract is considered to be a sale contract underlying a debt relation (the commodity is a debt on the seller). The consequence of this characterization is that the contract will have the same elements as the sale contract (i.e. parties, agreement, subject matter and price), and some features of debt contracts will be applicable, according to certain scholars, to the *salam* contract (e.g. guarantees, transfer of debts).

17. There are about six conditions of validity of the contract, but the most important are: (a) the capital should be paid immediately (it cannot be a debt); and (b) the buyer of the commodity cannot sell the commodity subject of the contract before the settlement of the contract. He can, however, enter into a parallel *salam* contract as a seller of a similar commodity. Other conditions of validity relate to the commodity, the term and the ability of the seller to deliver the commodity.

F. *Istisna'a*

18. *Istisna'a* is a particular form of sale whereby a party (the purchaser) places an order to another party (the manufacturer) to manufacture a specific commodity for a determined price.

19. The first issue that Islamic jurists had to address as far as *istisna'a* is concerned was the characterization of *istisna'a*, i.e. whether it is a contract or a simple (and unilateral) promise to deliver a manufactured commodity. Most scholars concluded that *istisna'a* is a contract binding for both parties (one to manufacture and deliver and the other to accept and pay).

20. A second issue discussed by scholars was the difference between *istisna'a* and other contracts, particularly *salam* and *ijara* (see sect. II.D and II.E).

21. For three of the four main schools of *fikh* (Islamic jurisprudence) viz. Maliki, Chafii and Hanbali schools, *istisna'a* is a form of *salam*. The only difference

between the two would relate to the type of commodity (manufactured commodities for *istisna'a*); elements and conditions of validity of the contract would be the same as for *salam*. Consequently, the full payment of the price in advance would be a condition of validity of *istisna'a*.

22. The Hanafi school, however, is of the opinion that *istisna'a* is a separate and different contract from *salam* (which is the prevailing opinion currently). The main points of difference between the two include the following, apart from the type of commodity: (a) advance payment of the price is not a condition in *istisna'a* (unlike *salam*); (b) time of delivery is an essential element in the *salam* contract, while it does not need to be necessarily fixed in *istisna'a*; and (c) once signed, the *salam* contract cannot be cancelled unilaterally, while the *istisna'a* can be cancelled before the manufacturer starts the work.

23. With respect to *ijara* contracts, scholars pointed out that the subject matter of *istisna'a* is the manufactured commodity, not the services of the manufacturer. This is what distinguishes the *istisna'a* contract from the *ijara* contract. *Istisna'a* can be used for project-financing in many sectors, including housing, manufacturing and infrastructure. Even Governments using modern contracts such as "Build-Operate-Transfer" agreements can structure such agreements in *istisna'a* contracts.

G. *Sukuk*

24. *Sukuk*, which are usually presented as the Islamic equivalent of conventional bonds, are better described as investment certificates that represent a proportionate ownership in an asset.

25. *Sukuk* are used to share risk, and might have been used in former days by merchants who wanted to equip a caravan, for example. Individuals would subscribe a proportion of the costs, and receive the corresponding profits (or share any loss). In this original form, *sukuk* resemble shares in a western joint stock company. The defining feature of *sukuk* is that the investor has a beneficial interest in assets proportional to the amount subscribed.

26. *Sukuk* may take different forms, depending on the way the master contract, on the basis of which *sukuk* are issued, is structured. Hence, we can find *salam sukuk*, *istisna'a sukuk* and *ijara sukuk* (the latter being the most familiar forms of *sukuk*), in addition to *mudaraba* and *musharaka sukuk* (or notes).

27. These various forms of *sukuk* are addressed below.

Salam sukuk

28. *Salam sukuk* represent a fractional ownership in the capital of a *salam* transaction. In order to finance the advance payment (see sect. II.E), the purchaser will have to issue certificates entitling ownership of the commodity. The buyers of the certificates will be interested in buying such certificates since the purchase price of the commodity will be relatively low. At the maturity of the certificates (which is the same as the maturity of the *salam* transaction), they will be entitled to the commodity, which, then can be sold at a higher price. The difference between this price and the purchase price represents the return of the certificates.

29. The question whether or not *salam sukuk* can be traded before their maturity raised a huge debate among scholars. Most scholars concluded that such trade is not permissible, because one cannot sell something that one does not have (in the *salam* contract the commodity is delivered only at maturity of the contract; before that date it might even be inexistent).

Istisna'a sukuk

30. *Istisna'a sukuk* represent a fractional share in an *istisna'a* project financing. The project consists in manufacturing or constructing an asset for a customer at a price to be paid in future instalments. The total amount of these instalments equals the total face value of the *sukuk*, in addition to a profit margin.

31. To issue the certificates, the customer provides the Islamic bank with the details of the project (specifications, timing, etc.), the bank prepares a tender document and invites contractors (who will effectively build the project) to submit bids in which they have to specify the timing of delivery of the project parts and the payment schedule. The payments will include the costs of the contractor and a profit element. Since the Islamic bank is expecting a stream of payments from the project, certificates can be issued on the basis of the income expected from the project.

Ijara sukuk

32. Under the *ijara* contract, an asset or a property is leased by the owner to another person for a rental payment. Typically, this will be considered a finance lease for financial accounting purposes. Since the lease will generate a fixed stream of income, securities (*sukuk*) can be issued.

33. *Ijara sukuk* represent, therefore, a proportionate ownership in a leased asset or property.

34. As to the arrangement to issue *ijara sukuk*, it usually starts with an enterprise that needs to finance an asset. To that end, it will go through a special purpose vehicle to raise funds from the public and issue certificates for the ownership of the asset. The proceeds of the issue will be used to buy the asset. The holders of the certificates will be the owners of the asset (assuming full responsibility of ownership). The asset will then be leased back to the enterprise, thereby generating a rental income to the holders.

35. Since *ijara sukuk* represent the ownership of an existing and well-defined asset, they may be traded in a secondary market at a price determined by market forces; they can also be rated.

Musharaka* and *mudaraba sukuk

36. The *musharaka* and *mudaraba sukuk* are equity instruments, and the return derived therefrom will be variable (unlike the *salam*, the *istisna'a* and the *ijara sukuk* contracts).

37. *Musharaka sukuk* represent a fractional ownership in the capital of a private commercial enterprise or project. *Sukuk* holders are entitled to a proportionate share of the profits and assume a proportionate share of the losses.

38. With respect to *mudaraba sukuk*, *sukuk* holders subscribe to the certificates issued by a *mudarib* (entrepreneur) and share the profit with the *mudarib*, but bear

(totally) any losses arising from the *mudaraba* operations. The returns to the holders are dependent on the revenue generated by the underlying investment. *Sukuk* holders are not registered owners and cannot attend or vote at the general assembly. One of the main features of *mudaraba sukuk* is that the *mudarib* (entrepreneur) does not guarantee the capital at maturity, but scholars recommended that such a guarantee should be "a voluntary commitment".

III. Tax issues related to Islamic financial instruments

39. These issues are mainly related to the characterization of the income derived from Islamic financial instruments. Tax treatment of those instruments will be a direct consequence of such characterization.

40. Two approaches can be adopted in this respect: a legal approach based on the form of the contract or transaction, and an economic approach based on the substance or the economic reality of the contract or transaction.

41. It should be noted that most countries where Islamic finance is practised have adopted the economic approach, albeit sometimes through specific legislation. The United Kingdom and Malaysia can be given as examples of the latter (specific legislation to clarify the tax treatment).

A. Legal approach

42. Under this approach, we look primarily to the legal characterization (or form) of the contract or instrument. As an immediate consequence of this approach, tax provisions applicable to interest payments would not apply to any of the Islamic financial instruments, because these instruments were designed in the first place to avoid any interest bearing debt relation.

43. Tax treatment of income from main Islamic financial instruments under the legal approach would be as follows.

Musharaka* and *mudaraba

44. Income derived from the typical *musharaka* contract is business income. It should be taxed as such by the source state if the activity amounts to a permanent establishment.

45. The same can be applied to the *mudaraba* contract, with the difference that the type of investment or activity carried on by the *mudarib* (entrepreneur) should be taken into consideration.

46. Note, however, that it is possible that payments made under certain profit-sharing and loss-sharing deposits (a sort of *musharaka* agreement) might be regarded as dividends under certain treaties. Relevant to the characterization will be both the facts of the case and the language of the treaty involved. For example, if article 11 of the applicable tax treaty does not contain the words "and whether or not carrying a right to participate in the debtor's profits" in article 11, then article 11 might not apply. In addition, it may be that, under the facts of the case, characterization as a dividend is appropriate, as called for in paragraph 25 of the commentary on article 10 of the OECD Model.

Murabaha, salam and istisna'a

47. In *murabaha, salam and istisna'a* contracts, the profit consists in a markup over a cost price of an asset, commodity or product. Therefore, most likely, it will be business income taxable by the source state only when the activity qualifies for the permanent establishment test.

Ijara

48. In *ijara* contracts, the income is derived from the lease of the asset subject matter of the contract. Therefore, it would be taxable under article 6 of the Model if the asset was an immovable property. If the asset was an aircraft or ship used in international traffic, then article 8 would apply. Otherwise, the income would be taxed as business income (if the permanent establishment test is met).

49. Note, however, that countries that, for domestic law purposes, regard finance leases in the same way as operating leases would most likely characterize the payments under the lease as payments of business profits or as royalties. Which of these applies will depend on the precise wording of the treaty (some treaties treat them as royalties payments for the use of equipment; this language is in the United Nations Model, but has been removed from the OECD Model).

Sukuk

50. Characterization of income from *sukuk* will follow, in principle, the characterization of the main contract on the basis of which *sukuk* were issued (*ijara, salam, istisna'a, mudaraba*, etc.). Therefore, from a purely legal point of view, the characterization of income will be as follows:

(a) In the case of *salam* and *istisna'a sukuk*, the income is a capital gain on securities (taxable, in principle, under article 13 of the Model);

(b) In the case of *ijara sukuk*, the characterization of the income will depend on the nature of the underlying asset; i.e. rent (taxable under article 6 of the Model), if the asset is an immovable property; if the asset is equipment, the income will be taxable under article 7 if the transaction qualifies for the permanent establishment test, etc.;

(c) In the case of *musharaka* and *mudaraba sukuk*, the characterization of the income will depend on the legal form of, and the activity carried on by, the enterprise or venture.

B. Economic approach

51. What matters under this approach is the economic reality of the transaction or contract. Tax authorities in countries following this approach will often recharacterize the income to reflect the substance of the contract (usually to assure the same (tax) treatment as that applicable to equivalent contracts in conventional finance).

Musharaka

52. The *musharaka* contract will be regarded as a form of partnership and will be taxed (if to be taxed) as such. Therefore, there will be no significant difference between the legal and economic characterization for this type of contract. This will not be true, however, as far as diminishing *musharaka* is concerned (see sect. II.A). Indeed, under the economic approach, payments to the financial institution would be characterized as payments of principal and interest on a loan. On the other hand, under the legal approach, these payments would be taxable as income from immovable property.

Mudaraba

53. The analysis here will focus on the main form of the *mudaraba* contract, namely, profit-sharing deposits (see sect. II.B.), which are the result of a *mudaraba* agreement between the depositor (*rabbu al-mal*) and the Islamic bank (*mudarib*).

54. Under a purely legal form, amounts credited to depositors under the agreement will be characterized as an equity return (see sect. III.A), in which case they will not be deductible by the lender.

55. Under an economic approach, the arrangement will be characterized as a debt relation, i.e. the deposits will be regarded as a liability of the Islamic bank, and the amounts credited to the depositor will be regarded as interest and taxed accordingly under article 11 of the Model. This will be the case of treaties that follow the current version of article 11 of the Model, which refers to "income from debt claims of every kind".

Murabaha

56. In countries following an economic approach to profit taxation, the *murabaha* transaction may be characterized as a loan. Payments made by the purchaser of the commodity will be characterized as loan reimbursement, decomposed into two elements: principal and interest. The latter will be taxable under article 11 of the Model.

Ijara

57. Under an economic (and accounting) approach, this transaction (where equivalent to a finance lease) will be accounted for like a loan. The nominal owner (lessor) will be considered a lender, the lessee will be considered a borrower, and the leased assets will be shown on the books of the lessee as assets that the lessee owns. Depreciation will accordingly be allocated to the lessee, and payments under the lease will be treated as interest and repayment of principal, rather than as rental payments.

58. Therefore, an *ijara* transaction would be treated in the same way as any other finance lease (where the specific details of the *ijara* lease correspond to the requirements under the applicable tax law for treatment as a finance lease). In most cases, this treatment will be the same as that of a conventional loan.

59. Countries that view finance leases as financing transactions under domestic law will likely characterize payments under the lease as consisting of payments of interest and principal under a loan, for treaty purposes. Under article 11 of treaties,

interest is defined as "income from debt claims of every kind". This definition does not depend on the domestic law characterization of the income. However, because the treaty language is worded broadly, countries that view a finance lease as representing a debt-claim in substance would likely take the same approach in applying the treaty, and hence would likely apply article 11.

Salam

60. In a *salam* transaction the income is a markup over the cost of a commodity. As an illustration, we consider an Islamic bank (IB) in country A that enters into a *salam* contract with a farmer (F) in country B. Under the contract, F will provide IB with x tons of cotton in six months against a price of K dollars. At the maturity of the contract, IB will sell the cotton to a textile manufacturer in country A at K' dollars. The gain of IB will be the difference between K and K', taxable as business income. Under the model, F will not be taxable in country A since he will not have a permanent establishment therein.

61. Under the transaction described above, the bank does not receive any payment that could be decomposed into principal and interest. Instead, it receives a commodity that would be sold to another person. Therefore, under both legal and economic approaches, income from a *salam* transaction would most probably be characterized as business income and would be taxed accordingly (if the permanent establishment test is met).

Istisna'a

62. In practice, where a client enters into an *istisna'a* contract with an Islamic bank to buy a manufactured commodity — e.g. a plant — the bank will not manufacture the plant. Instead, it will enter into a parallel *istisna'a* contract (as a buyer) with a manufacturer.

63. In determining the price to be paid by the client, the bank will take into account the price that it has to pay to the manufacturer. The profit of the bank will be the difference between the two prices. The profit of the manufacturer will be the difference between its costs and the price paid by the bank. The price to be paid by the client to the bank does not need to be paid in advance (see sect. III.1); it can be paid by instalments from the revenues of the plant.

64. Following is an example of determining the tax treatment applicable to the *istisna'a* as described above: C, a company resident in country A, signed an *istisna'a* contract with an Islamic bank (IS) resident in country B, whereby IS provided C with an air-conditioning plant against the payment of k USD, payable in 48 equal monthly instalments as of the operation of the plant. To this end, IS entered into a parallel *istisna'a* contract with a renowned air-conditioning manufacturer resident in country C. IS will have to pay k' USD to the manufacturer. The profit of IS is equal to the difference (k-k').

65. Under the legal approach (see sect. II.F), such profit would be regarded as business profits under the Model, and thus IS would not be taxed in country A since it does not have a permanent establishment. Payments made by C would be capitalized and a depreciation allowance would be deductible.

66. However, from an economic point of view, it is likely that the relation between C and IS would be considered as debt relation, and the monthly payments made by

C would be analysed as reimbursement of a loan. Each payment would be composed of two elements: a capital (equal to a portion of *k'*) and a profit element (equal to a portion of the difference (*k-k'*)). The latter would be analysed as interest and taxed accordingly, under article 11 of the Model, in the hands of IS and deductible at the level of C.

Sukuk

67. The return on *salam* and *istisna'a sukuk* is the difference between the purchase and sale prices of the certificates. The return on *ijara sukuk* is a portion of the rent of the underlying asset. The return on *musharaka* and *mudaraba sukuk* is a portion of the profits realized by the enterprise or venture.

68. From an economic point of view, income from different *sukuk* would generally be characterized as interest and taxed accordingly, except for *musharaka* and *salam sukuk*, in respect of which the economic characterization should not be very different from the legal characterization (see sect. III.A).

C. Illustration: United Kingdom and Malaysia cases

United Kingdom case

69. As mentioned earlier in this paper, the United Kingdom seems to have adopted the economic approach in dealing with Islamic financial instruments. The following can be given as illustration:

(a) Diminishing *musharaka*: under United Kingdom legislation, a diminishing *musharaka* arrangement is characterized as a loan, and the payment (the rent) is recharacterized as interest for tax purposes;

(b) Profit-sharing deposits: the United Kingdom Finance Act 2005 defines "profit share returns" and characterizes them as interest for purposes of individual income tax and corporation tax. A similar arrangement would be to deposit money in the bank under a *wakala* agreement (literally, *wakala* means agency). Under this arrangement, a customer would go to a bank with money to invest, and the bank would become an agent to invest that money. The customer would receive an agreed profit share, with the customer paying a variable incentive fee to the bank, which would consist of the excess that the bank earns. For tax purposes, the agency arrangement creates uncertainty about the amount the investor should be taxed, so the United Kingdom treats the actual return he receives as interest, and ignores, for the purposes of taxing him, any extra the bank has received as his agent; this is taxed in the hands of the bank;

(c) *Murabaha*: United Kingdom law recharacterized the *murabaha* arrangement (see sect. II.C) as a loan with the effect that the bank is taxable on the interest element of the loan, and the user of the equipment receives a corresponding deduction (subject to the normal rules of eligibility). On the other hand, it is worth mentioning that, although *murabaha* (and other Islamic finance arrangements) may involve transactions that could be interpreted as trading, the United Kingdom legislation specifically provides that a United Kingdom non-resident who is party to such arrangements is not, as a result, treated as trading in the United Kingdom through a permanent establishment or through a United Kingdom agent;

(d) *Ijara*: under United Kingdom law, *ijara* contracts are subject to the ordinary tax rules applicable to finance and operating leases. As to *ijara waktina* (see sect. II.D), which can be decomposed into a pair of contracts — one for the hire of the asset, and one for its purchase at the end of the hire period — the United Kingdom has legislated to treat two or more contracts as a single contract;

(e) *Sukuk* (see sect. II.G): these arrangements are being dealt with in the Finance Bill 2007, which is currently before Parliament. From the point of view of the issuer and the investor, cash flows are treated for tax purposes in accordance with their economic substance, be this interest, discount or repayment of capital. Parity of treatment with conventional bonds extends to treating the *sukuk* as qualifying corporate bonds where appropriate, so that no capital gains tax is payable by non-corporate investors. Under the Financial Services and Markets Act of 2000, *sukuk* are considered for regulatory purposes (but not for tax purposes) to be collective investment schemes.

Malaysia case

70. Malaysia introduced a number of changes to its tax legislation to deal with Islamic financial instruments. The main purpose of these changes, which reflect an economic approach (as opposed to the legal or form-based approach) in dealing with Islamic finance, was to assure an equal treatment of these instruments and their counterpart in conventional finance.

71. The main changes were as follows:

(a) Amendment of the Income Tax Act (ITA) of 1967 to include a new section 2 (7), which provides that: "[a]ny reference in this act to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance to the principles of Syariah [Sharia]". The result of this amendment is that income derived from Islamic financial instruments that would have been classified as interest if a conventional instrument was used will be treated as interest for the purposes of the Income Tax Act of 1967;

(b) Under the Real Property Gains Tax Act 1976, a tax is imposed on gains on the disposal of real property (or shares in a real property holding company) made by a person not involved in the business of dealing in real property. This tax affects banks and persons involved in Islamic financial arrangements. Under *murabaha*, for instance, the Islamic bank is liable for this tax because it purchases and resells the real property. To avoid the adverse effect that this tax has on the development of Islamic financial instruments, the Real Property Gains Tax Act 1976 was amended, with the effect to exempt gains on the disposal of real property by a client to an Islamic bank under an Islamic financial arrangement. As to the sale back of the real property by the bank to the client, the gains should be taxed as business income at the level of the bank (and exempt from the real property gains tax) following the amendment of the Income Tax Act mentioned above;

(c) Owing to the multiplicity of transactions under Islamic financial arrangements, the exposure of these arrangements to stamp duties is increased. To avoid the impact of such exposure on the development of Islamic finance, the Stamp Duty Act 1949 was amended, with the effect to tax only the financing document and not the second purchase document between the financier and the client.

IV. Conclusions

72. There is a variety of Islamic financial arrangements, and the tax consequences of any given arrangement may depend on the specific facts of the case and on the details of the tax laws of the country concerned. Therefore, it is very difficult to draw general conclusions as to the taxation of Islamic financial instruments. But, as a general remark, we may distinguish between two approaches in this respect, a legal approach, which looks at the form of (Islamic financial) transactions, and an economic approach, which looks at the substance thereof.

73. Most countries where Islamic finance is practised seem to have adopted the economic approach to assure an equal treatment for tax purposes of Islamic instruments as compared to their conventional counterparts. Even countries that generally follow the legal approach to taxation (e.g. the United Kingdom) have enacted special legislation to treat Islamic instruments according to their substance, following thereby the economic approach in this area. The adoption of the legal approach would lead to "anomalies" in the tax treatment of Islamic instruments that adversely affect their development. The economic approach suggests the application of article 11 of the Model to Islamic financial instruments.

74. It is not clear whether or not there is a need for the United Nations Model or the commentary to deal specifically with Islamic financial transactions. But, generally speaking, there seems to be a consensus (within the working group) that the Model, as currently drafted, is capable of covering Islamic financial transactions. Any difficulties in their characterization would arise more from the approach of the domestic law of each treaty partner rather than from the Model itself. As to the commentary, although it is difficult to propose a solution that covers all possible cases in the light of the variety of transactions and the diversity of their treatment under domestic laws, some are of the opinion that we should add some language in the commentary of article 11 of the Model to say that the definition of interest would include income from some types of Islamic financial instruments that are deemed to be debt relations (although, legally, they are not). More details could also be included in the negotiation manual to give some guidance in bilateral situations, in order to decide whether or not some language on Islamic finance is needed to be included in the treaty.